retransmission consent and copyright fees, and other programming costs. Each of these activities, except for franchise fees, can be directly assigned to the specific tier implicated by the exogenous change. Franchise fees are permitted to be separately itemized and passed through. The Commission should clarify that, since external costs are to be directly assigned, there is no need for cost allocation rules for external costs.

VI. A UNIFORM SYSTEM OF ACCOUNTS SHOULD NOT BE REQUIRED FOR ANY CABLE OPERATOR.

The Commission should not impose a uniform accounting system for cable operators electing cost-of-service regulation. Inflicting such obligations on cable operators imposes on them burdensome forms of public utility regulation proscribed by Congress. Further, these burdens are unnecessary in light of the fact that cable rate regulation is temporary and transitional.

A. Imposition of a Uniform System of Accounts on Cable Operators is Prohibited by the Communications Act.

As the Commission acknowledged in the Notice,[28] a uniform system of accounts is a standard feature of Title II common carrier regulation. The USOA obligations proposed to be imposed on cable operators (including those under benchmark regulation

[28] The Commission acknowledged that uniform accounting systems have "long been recognized as . . . important component[s] of cost-of-service regulation." Cost-of-Service Order at para. 220. And, although federal and state commissions have adopted USOAs for gas, electric, and telephone companies, there is no correlation, nor should there be, between the regulation of the cable industry, a non-essential service, and the regulation of essential utilities. See id. at para. 220, fn. 434.

that seek external cost adjustments) are Title II,common carrier regulation expressly foreclosed by section 621(c) of the Communications Act.[29]

B. A Uniform System of Accounts is Unduly Burdensome and Unnecessary.

The Commission's statement that "neither GAAP nor the interim summary level accounts will adequately provide, in the long run, for uniform accounting practices"[30] assumes without explanation that uniform practices are necessary. It is also inconsistent with the notion that cable price regulation is a transitional and temporary measure. Cable price regulation under the 1992 Cable Act is based wholly on the perceived need to simulate marketplace forces. Once the marketplace becomes "effectively competitive" as defined by the Cable Act, cable systems will no longer be subject to price regulation. Given the advances made in wireless cable, DBS, and other terrestrial delivery systems, it will only take a few years before most cable systems are classified as "effectively" competitive. To impose the substantial burdens and costs of developing a uniform accounting system on these cable systems is unreasonable and unnecessary.

The Commission apparently believes that its proposal to mandate a USOA for the cable industry will not entail significant burden or expense for the industry. That is not the case. As

---

[29] 47 U.S.C. § 541(c).

[30] Id. at para. 219.

noted in the accompanying affidavit of Mr. Robison very substantial burdens and expenses will be associated with the enormous task of creating accounting data in a confusing array of classifications, categories, and levels of detail not required by the GAAP accounting practices historically followed by the cable television industry. The Commission apparently overlooks the fact that the telephone industry's accounting practices have evolved over a century to accommodate and harmonize GAAP and regulatory accounting requirements.[31] The cable industry has had no such history and it is therefore incorrect to assume, as the Commission does in footnote 569 of the Further Notice, that minimal changes in accounting practices would be necessary to accommodate the proposed USOA.

To illustrate this point, the accompanying affidavit of Mr. Robison discusses one example of the disparity between historical GAAP accounting practices of the cable television industry and the traditional USOA treatment of capitalization of funds used during construction. The Allowance for Funds Used During Construction (AFUDC) proposed in the USOA differs materially from the comparable treatment of the same amounts under Statement of Accounting Standards No. 34. These and numerous other disparities would likely lead cable companies to bear -- and pass on to their customers -- the cost of maintaining separate books for financial and regulatory purposes.

[31] It bears repetition that Congress did not intend that cable price regulation remain in place for even the next decade, much less the next century.

Against these significant costs, the Commission identifies no significant benefit to be achieved by imposition of a regulatory USOA. The Commission identifies no reason to doubt the accuracy or sufficiency of accounting practices and records that already meet the stringent legal requirements for financial accounting by publicly-traded companies, such as TCI.[32] The proposed imposition of a USOA does not pass a cost-benefit analysis.

C. A USOA Based on the Telephone Company Model Would be Highly Inappropriate Even if it were Permissible.

The FCC's proposed USOA for cable is conceded to be a slightly modified version of the USOA for Class B telephone companies. The telco USOA is not an appropriate model on which to base a uniform accounting system for cable. Contrary to the Commission's proposal, the telco accounts are not transferrable to the cable USOA. Simply adding accounts specific to cable will not correct the overall problems associated with using a telco based system for cable.

The difficulty with adopting a USOA is readily apparent from the Commission's telco experience. From 1935 until 1988, the Commission utilized a USOA which largely mirrored the Interstate

---

[32] The Securities Exchange Commission relies on GAAP. Compliance with GAAP is more than adequate to determine the reasonableness of rates charged by cable operators that elect cost-of-service regulation.

Commerce Commission's accounting system. Technical advances and other market and regulatory developments made this USOA unsuitable for telephony:

> That USOA was a creature of its times, adapted to the regulatory and industry environment of the regulated monopoly area. Over the last two decades, as technical advances, the growth of competition, the proliferation of new products and services, and changes in industry structure dramatically altered that environment, the old USOA become obsolete.[33]

In 1978, the FCC undertook to revise the old USOA. It took an entire decade, from 1978 to 1988, to implement final telephony accounting rules.[34] This experience is telling because it demonstrates the difficulties inherent in developing accurate accounting requirements as it took literally decades to develop a workable accounting system. It is thus highly unlikely that a USOA for cable could be adopted and implemented in the short time that most cable systems will be subject to price regulation.

---

[33] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, 2 FCC Rcd 1298, 1300 (1987).

[34] Revision of the Uniform System of Accounts and Final Reporting Requirements for Class A and Class B Telephone Companies, 60 Rad. Reg. 2d 1111 (1987).

VII. THE INTERIM RULES REGARDING CAPITAL ON WHICH A RETURN IS TO BE EARNED ("RATEBASE") MUST BE REVISED IF THEY ARE LEFT IN PLACE.

A. A Presumption Against Allowance of "Excess" Acquisition Costs in the Ratebase Unfairly Penalizes Cable Operators.

The Commission's presumptive[35] disallowance of what it calls "excess" acquisition costs from the capital on which a return may be earned ("ratebase") is based on the incorrect assumption that acquisition prices, in the period prior to the adoption of the Cable Act, represent "amounts paid in expectation of supracompetitive profits, growth premiums for unregulated

---

[35] The Commission's tentative conclusion that the use of presumptions will effectively preserve the "safety net" function of the backstop regulatory mechanism is unfounded and untrue. The Commission has adopted these presumptions, apparently convinced that they impose no real burden on companies truly subject to unusually high costs of doing business. But, as courts have recognized, that simply is not the case. See Mountain States Tel. and Tel. Co. v. FCC, 939 F.2d 1021, 1028-29 (D.C. Cir. 1991) (presumptive exclusion of certain litigation expenses as costs of doing business for ratemaking purposes in and of itself "inflicted hardship upon the carriers"). Each presumption against inclusion of costs in the ratebase will have direct and adverse consequences for the cable industry.

More significantly, the accumulated presumptions in the cost-of-service rules, taken together, deprive cable operators of any true relief as the burden to overcome these presumptions is extremely difficult, expensive, and uncertain. Such presumptions, in effect, nullify the Commission's *pro forma* declaration that cost-of-service is a backstop method of regulation for cable systems subject to unusually high costs. See Federal Land Bank of Springfield v. Farm Credit Admin., 676 F. Supp. 1239, 1251-1252 (D. Mass. 1987) (Farm Credit Administration's regulations' many presumptions, considered as a whole, nullified recital of statutory criteria and were therefore unlawful).

services, and . . . simple overpayments."[36] Such conjecture is mistaken and unjust.

The Commission's presumptive disallowance of "excess acquisition costs" ignores efficiency gains obtained through system acquisitions.[37] The fact is that acquisitions are made for a number of reasons, yielding benefits to both investors and subscribers alike. A cable company, for example, may acquire neighboring systems to capture efficiencies from "clustering" its operations. The price paid for the system will undoubtedly reflect these efficiencies. Some acquisitions are made because the MSO believes that it could operate the systems more efficiently, i.e., with lower programming, management, and equipment costs. This greater value is also reflected in the purchase price paid for the assets. To require precise proof of these efficiencies is, in effect, to disallow them from the ratebase.

Further, the price paid to the seller of a cable system during the past decade or so typically included return of and on the losses, earnings deficiencies, and opportunity costs incurred by the seller from inception to sale. This portion of the purchase price, often booked as "goodwill" or franchise investment, represents a legitimate return to the seller and a legitimate cost to the buyer. There is no lawful basis for

---

[36] Cost-of-Service Order at para. 82.

[37] The Commission also ignores the fact that investment decisions by cable operators were made free of any regulatory distortions and thus are presumptively efficiency-producing.

excluding return of and on these amounts now on the books of the buyer. Moreover, even if one assumes that cable exercises some degree of monopoly power, goodwill can and often does yield value to the cable system.[38] Goodwill can be defined as "a category of factors that increase demand . . . ."[39] Price is but one factor that induces consumers to purchase goods; others include the reputation of the company, the quality of the good provided, and the service rendered to the consumer. So long as demand is at all elastic, value from goodwill is present even from a monopolist that has the ability to charge a higher monetary price for its goods without losing customers. This is so because its customers perceive that the firm offers savings, for example, in terms of the company's reputation, service, and quality. The very fact that a monopolist faces price-sensitive demand for its products implies the potential existence and value of goodwill.[40]

In this context, goodwill does not represent the expectation of supracompetitive profits but rather the ability to attract customers "because of [the firm's] reputation, service and the fact that its potential patrons feel good about patronizing it

---

[38] See Joshua G. Genser, "The Economic Case for the Coexistence of Monopoly Power and Goodwill in the Cable Television Industry," 16 Hastings Comm/Ent L.J. 265 (1994).

[39] Id. at 273

[40] Unlike traditional public utilities, such as gas, electricity, telephony, water, etc., where demand is highly inelastic, demand for cable service is elastic. Over 35 percent of the homes passed do not subscribe to cable service.

. . . . "[41] Goodwill is thus a valuable asset that properly should be reflected in the purchase price of the cable system. A presumptive disallowance of "excess" acquisition costs in the ratebase ignores the legitimate value of such goodwill.

There is, of course, a real problem of documentation and quantification of the amounts attributable to these and other legitimate intangibles, because there was no business or accounting reason for them to be separately valued and recorded at the time of the transactions. There was also no incentive for operators to inflate the amounts booked to intangibles in connection with an acquisition.[42] Therefore, the reasoned approach would be to start with a presumption that an operator's audited, historical books and records fairly reflect the capital -- tangible and intangible -- on which it is entitled to earn a return.

The Commission's presumptive disallowance from the ratebase of intangible capital is contrary to its conclusion that the Cable Act's objective is to set prices that reflect the costs of competitive systems. In a competitive market, prices will include a normal return on capital, including the acquisition of intangibles. A buyer of a competitive firm pays a price for the firm that includes both intangible and tangible assets, and is

---

41 Genser at 274.

42 Prior to recent IRS tax cases, there existed significant controversy regarding the deductibility of the amortization of intangibles, thereby creating a disincentive for TCI to record amounts to intangibles. In certain periods, the tax lives were longer for intangibles than for tangible assets.

clearly entitled to the opportunity to earn a return on that investment. The Commission's rules should allow the same.

Even the Commission's treatment of acquired plant by telephone companies is not as simplistic or as generalized as its approach to cable acquisitions. The Commission's regulation of telephone company plant acquisitions has proceeded in a more individualized fashion by focusing on the particular circumstances of the acquisition, such as whether the acquired plant was carrying traffic, the purchase price was below a nominal amount, or the acquisition was made from an affiliate.[43] The Commission's preference for a case-by-case approach based on individual showings was explained in the Ratebase Reconsideration Order:

> While parties ask that we develop specific criteria for approval of plant acquisition adjustments, we believe that the nature of the acquisitions under which they take place are highly diverse and specific criteria can not be developed for all situations.[44]

The Commission's presumptive exclusion of "excess" acquisition costs by cable operators is inconsistent with the case-by-case approach taken for telco acquired plant.

---

[43] For example, acquired plant from a non-affiliate that is not carrying traffic is presumptively included in the ratebase. Decision on Remand in CC Docket No. 86-497, 7 FCC Rcd 296 (1991).

[44] Ratebase Reconsideration Order, 4 FCC Rcd 1697, 1705 (1989), aff'd sub nom., Illinois Bell Telephone Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993).

Because a disallowance of "excess" acquisition costs could have an adverse impact on the cable industry,[45] TCI urges the Commission to adopt transitional rules that would permit for some period of time a recovery of and return on this investment. Both this Commission and the Courts have recognized the need for transition mechanisms for industries adjusting to a new or different regulatory environment.[46] Transition rules are especially appropriate here where the acquisition costs were funded by investors who could not have known that such costs would be presumptively disallowed in the future.[47] Transition mechanisms have also been applied in the telco context, where the Commission grandfathered existing acquisition adjustments of acquired plant costs, and applied the new rules prospectively.[48]

In recognition of the interrelationship between including or excluding "excess" acquisition costs in the ratebase and the methodology employed for valuing plant,[49] TCI offers an alternative solution that would avoid adverse effects on cable operators and protect consumer interests. TCI proposes that ratebase be given the value of invested capital less depreciation

---

[45] See Cost-of-Service Order at n. 178.

[46] Communications Satellite Corporation v. FCC, 611 F.2d 883, 908 (D.C. Cir. 1977).

[47] Id. (held that the Commission abused its discretion when it assumed a 45% debt ratio because Comsat was not aware of the consequences of its capital structure until the time of the Commission decision).

[48] Ratebase Reconsideration Order at 1705.

[49] Cost-of-Service Order at para. 89.

reflected on the cable operator's existing audited books, subject to adjustment only where those books are inaccurate or incomplete.

Conceptually, this would be analogous to the "fair value" approach to ratebase valuation common in the early part of this century. It seems no accident that the fair value approach was adopted at the time when unregulated companies were being brought under rate regulation for the first time, since this approach serves to obviate difficult constitutional (Fifth Amendment takings clause) questions. TCI envisions that the Commission might well determine to apply the currently accepted notions of "original cost" for ratebase items on a going-forward basis. This approach would provide a transition, consistent with the history of regulation generally in this century, from unregulated existence, through "fair value" regulation, to "original cost" regulation.[50]

Although the Supreme Court has ruled that the "fair value" approach to ratebase valuation is not required,[51] it certainly did not foreclose the use of this approach where warranted. The Commission expressly acknowledged that it might use a fair value approach in the Cost-of-Service Order. The practical problems that the Commission relied on in deciding tentatively not to

---

[50] See Charles F. Phillips, Jr. The Regulation of Public Utilities: Theory & Practice (1985)

[51] See Permian Basin Area Rate Cases, 390 U.S. 747 (1968); FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); Duquesne Light v. Barasch Co., 488 U.S. 299 (1989)

employ a "fair value" approach[52] are obviated where audited books and records are used as the basis for valuation.

There are no constitutional impediments to adopting a "fair value" standard for valuing invested capital following acquisitions. In fact, the Supreme Court declined in Duquesne to adopt original cost as the constitutional standard, noting that the "designation of a single theory of ratemaking as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors."[53] The cable industry clearly falls within this category. Accordingly, TCI urges the Commission to adopt a "backstop" regulatory mechanism that starts with an operator's actual audited books and seeks to ensure the opportunity for recovery of the expenses and a reasonable return on and of the capital shown on those books in the allowed prices. The audited books of cable operators provide a sound basis for determining "fair value" as they are kept in accordance with GAAP.

B. There is no Basis or Need for a Rigid or Presumptive Limitation on Recovery of Start-up Losses.

Having determined to impose some sort of limitation on recovery of and on start-up losses, the Commission seized upon an accounting guideline -- FAS 51 -- that deals with capitalization of certain start-up losses during a "prematurity period," defined as a period when the cable system is partly in service and partly

---

52 Cost-of-Service Order at paras. 57 and 64.

53 Duquesne at 316.

under construction. FAS 51 sets a general guideline of two years for the prematurity period, but notes that it will vary from system to system and that a period longer than two years may well be justifiable in "major urban markets."

It is noteworthy that FAS 51 provides no basis whatsoever for a rigid two year limit on recovery of start-up costs. It imposes no such rigid limit for any purpose. Despite the goal of standardizing industry accounting practices under GAAP, FAS 51 recognizes the highly individualized nature of particular cable systems' experiences.

As discussed more fully in the accompanying affidavit of Mr. Robison, FAS 51 addresses a particular and narrow issue in cable television accounting -- certain kinds of fixed costs in the "prematurity period" -- and does not concern the variable costs that make up most of the costs giving rise to start-up losses for cable systems. Furthermore, FAS 51 was not intended to be used in connection with, and did not consider, cost-of-service regulation.

The Commission should not impose any arbitrary or a priori limits on recovery of start-up losses, but should instead permit the recovery of all such losses over a period of time that is reasonable for the particular system at issue.

C. The Commission Should Clarify its Treatment of Plant Under Construction.

TCI believes that the interim and proposed USOAs for cable are impermissible, unduly burdensome, and unnecessary. However, should the Commission maintain or adopt a USOA for cable, it should at least clarify the treatment of plant under construction.

The USOA for telephone companies contain Account 2003: Telecommunications plant under construction -- short term and Account 2004: Telecommunications plant under construction -- long term.[54] The proposed USOA for cable, however, does not include accounts analogous to these telco accounts. TCI assumes that this is an oversight, given that the cost-of-service rules require cable operators to maintain a summary account entitled "Plant Under Construction."[55] Similarly, in § 76.1133(b)(2)(ii) of the Commission's proposed accounting rules, there is a reference to an account entitled "Cable Services Plant Under Construction," which is not further defined or discussed in the proposed accounting rules or Cost-of-Service Order. TCI asks that the Commission provide clarification on this issue.

More importantly, the telco USOA Account 2003 dealing with short term construction projects provides that the cost of any construction project that is estimated to be completed and ready for service within two months from the date on which the project was begun may be charged directly to the ratebase. The same holds true for gross additions to plant which are estimated to have a construction cost of less than $100,000. Because there is no similar USOA account for cable, this immediate ratebase

---

[54] See 47 C.F.R. §§ 32.2003 and 32.2004.

[55] See Id. §§ 76.924(d)(1) and (2).

treatment for a cable operator's short-term construction projects would not be permitted. The Commission's asymmetrical treatment of cable and telco short term plant under construction is nowhere explained. TCI therefore requests that similar treatment be extended to cable. TCI also asks the Commission to define the term, "allowance for funds used during construction," in the cable system of accounts. This term is defined in the telco USOA in Account 2000: Instructions for telecommunications plant accounts.[56] This omission is curious given that the other thirteen definitions contained in the "cost of construction" provision of the telco USOA were included in the proposed accounting rules for cable.[57]

VIII. THE COMMISSION SHOULD NOT PRESCRIBE A RATE OF RETURN.

A. The Commission's Experience with a Unitary Rate of Return for Telcos is Inapplicable to Cable.

The basic problem with prescribing an overall rate of return for the cable industry is that it is based upon the Commission's experience with telephone company regulation. For several reasons, which are discussed below, that experience is inapplicable here.

---

[56] See Id. § 32.2000(c)(2)(x) which contains a lengthy definition of "allowance for funds used during construction."

[57] Compare 47 C.F.R. § 32.2000(c)(2) with 47 C.F.R. § 76.1133(c)(2). Instead, the cable rules provide that the actual money cost of plant may include an allowance for funds used during construction at the primary rate or at the operator's actual cost of funds during construction.

Cost-of-service regulation serves a fundamentally different purpose for the cable industry than it does for the telephone industry. Whereas cost-of-service regulation functions as the primary form of regulating telephone rates, the Commission intends that it serve exclusively as a secondary method of regulation for cable. This distinction alone explains why it is appropriate to prescribe an averaged industry-wide rate of return for telephony but not for cable.

In promulgating an industry-wide rate of return for the local exchange industry, the Commission is fulfilling its obligation under the Communications Act through the mechanisms established in Title II. Administrative expediency may thus serve as a rationale for regulating an entire industry where the Commission has been instructed to regulate the industry on that basis, and where the alternative is to develop over 1,000 individual company costs for firms that are, in fact, not that dissimilar. Administrative efficiency cannot serve, however, as the basis for regulating cable prices where, as here, the Commission is explicitly forbidden to regulate on a rate of return basis, and where it is regulating only by exception.

Moreover, an averaged, industry-wide rate of return cannot, by definition, fulfill the necessary backstop function of cost-of-service regulation. Simply put, if cost-of-service regulation is intended to be used by the outliers, i.e., those cable companies whose costs exceed the average, the Commission needs to prescribe a rate of return that reflects the returns required to attract and compensate the investors in the company seeking backstop relief. By its own terms, an averaged rate of return fails to achieve this result.

The telco experience is irrelevant not only because cost-of-service regulation serves different regulatory purposes for cable and telephony, but also because these two industries are so disparate. Important similarities between local exchange carriers gave a certain logic to prescribing an industry-wide rate of return:

> [T]he RBOCs were purposely set up as seven companies that are quite similar . . . . [T]he RBOCs were divested with similar capital structures, have similar operating assets, and are all about the same size. Their credit ratings are similar. They share the same regulatory environment, and their management share a common heritage.[58]

These same findings cannot be made for the cable industry. Cable operators were not "set up" to be similar; rather, these firms developed independently across the nation according to individual franchise agreements. Further, cable systems operate in a variety of ways, some as corporations, others as sole proprietorships or partnerships. Cable operators do not necessarily have similar capital structures, or operating assets, are not close to being the same size, do not have the same credit ratings, and most certainly do not share a common management

---

[58] Supplemental Notice of Proposed Rulemaking, CC Docket No. 84-800, FCC 85-458, 50 Fed. Reg. 33786, 33790 (1985).

heritage.[59] Most importantly, cable operators do not share the same risks as telcos. The competitive and regulatory risks faced by cable operators are far greater. Thus, the rationale for establishing a unitary rate of return for telcos does not obtain here.

The homogeneity among telephone companies also extends to the services provided across telcos:

> All exchange carriers' interstate service is subject to the same regulator and is sold to the same interexchange carrier customers through a similar system of access charges. For non-traffic sensitive interstate plant, there continues to be a pooling and sharing of risks among all exchange carriers through the NECA. Moreover, interstate exchange service is not an independent service. Rather, it is useful only when provided as a necessary component of interstate toll service . . . .[60]

In contrast, none of these factors exists in the cable industry. Cable price regulation, for example, is implemented at both the local and federal level. Cable operators also do not provide, or even offer, the same services to customers. Further, there is no pooling or sharing of risks among cable systems.

---

[59] TCI's debt securities, for example, are currently rated as investment grade by all accredited rating agencies, a situation not widely common among other cable operators. Tele-Communications, Inc. Annual Report for 1992 at 5. Further, TCI's capital structure is vastly different from several of the other operators that are public companies.

[60] Supplemental Notice of Proposed Rulemaking at 33789.

B. **The Commission Should Heed the Experience of Other Regulatory Agencies' Failed Efforts to Establish Industry-Wide Rates of Return.**

The Commission should examine and take notice of other regulatory agencies' unsuccessful efforts to implement industry-wide unitary rates of return. In 1982, the Federal Energy Regulatory Commission ("FERC") proposed to implement an industry-wide rate of return on equity for electric utilities.[61] The Notice laid out a scheme that would divide the electric industry into three classes based on relative risk. FERC proposed to implement a rate of return for each class unless waived because of "unusual circumstances."[62]

Only two years later, FERC rejected its mandatory, unitary rate of return proposal and instead decided to calculate generic rates of return on equity for the industry on an advisory basis only.[63] FERC explained that a mandatory approach was ill-

---

[61] Generic Determination of Rate of Return on Common Equity for Electric Utilities, Notice of Proposed Rulemaking, 47 Fed. Reg. 38332 (August 31, 1982).

[62] Id. at 38337. Initially, FERC contemplated using one overall rate-of-return for the entire industry, but the proposal was flatly rejected:

> [FERC] believes [it] would be inappropriate to impose [one overall rate-of-return] on a mature industry comprised of companies with significant differences in both capital structure ratios and embedded costs of debt and preferred stock. Such an approach would likely yield excessive rates of return on common equity for some companies and inadequate ones for other companies.

Generic Determination of Rate of Return on Common Equity for Electric Utilities, 49 Fed. Reg. 29946, 26667 (July 25, 1984).

[63] See id. at 29946.

advised, given the evidence in the record that the electric industry was not sufficiently homogenous and that the risk classification system was technically unworkable and unduly burdensome.[64] FERC further announced its plans, beginning in 1987, to use the industry-wide rates of return as establishing a rebuttable presumption for the allowable rate of return for individual electric companies.

For seven years, FERC annually calculated advisory-only "benchmark" rates of return for the electric industry. Importantly, during that process, FERC decided that it should not apply a "rebuttable presumption" standard to these benchmarks, as it had planned.[65] And, in 1992, FERC decided to abandon the generic rate of return determinations on equity altogether, noting that "the [advisory generic rate of return] benchmark has only rarely been adopted or used in determining the allowed rate of return in individual cases."[66] FERC found that the anticipated benefits of an advisory-only generic rate of return were never realized:

> [A]nticipated benefits of the benchmark have failed to materialize and the annual benchmark proceedings have not saved resources . . . . Despite arguments to the contrary, in the Commission's experience, the benchmark has not reduced the parties' uncertainty in rate cases

---

[64] Id. at 29947-29951.

[65] Generic Determination of Rate of Return on Common Equity for Electric Utilities: Final Rule, 52 Fed. Reg. 11 (January 2, 1987).

[66] Generic Determination of Rate of Return on Common Equity for Electric Utilities: Final Rule, 57 Fed. Reg. 802 (January 9, 1992).

> as to what will be the Commission's ultimate determination. Thus hopes of conserving resources and enhanced certainty have not been fulfilled. The Commission's experience also shows that the annual generic benchmark proceedings have not provided the Commission with a significantly better understanding of industry trends, nor provided an appropriate forum to study financial and operating circumstances of the electric utility industry. Moreover, the Commission does not believe that the benchmark provides any special protection to consumers from excessive rates and charges.[67]

The FCC's unitary rate of return presumption for cable is very similar to the approach proposed, but ultimately rejected, by FERC. The Commission should learn from FERC's errors and not make the same mistakes.

C. The Commission Must Make Rate of Return Determinations on a Case-by-Case Basis with Adjustments Made to Reflect the Regulatory Risks of Disallowance.

The Commission asks in the Notice for "data and expert analyses" regarding the risks of regulated cable service and the effects of the Commission's rate regulations on those risks.[68] While this is a crucially important question, it cannot be answered at this early stage in the process, where regulations are still being developed and continually being changed and reinterpreted. The increased costs and diminished revenues associated with regulation have already made it substantially more difficult for cable operators to attract capital. It is impossible, however, to offer meaningful data or "expert analyses" in these circumstances. This is just one more reason

---

[67] Id. at 805 (footnotes omitted).

[68] Further Notice at para. 305.

why averages, generalizations, and presumptions are inappropriate for a backstop regulatory mechanism.

Given the heterogeneity of the cable industry, a unitary rate of return will not reflect the actual cost elements for all cable operators, and the ever-changing regulatory landscape will cause the necessary return for any particular operator to fluctuate over relatively short time periods. Thus, in order for backstop regulation to serve its intended purpose, the Commission must afford each cable operator the opportunity to support its own specific costs, rate of return needs, and capital structure as part of a cost-of-service proceeding.

The Commission's rate of return prescription of 11.25 percent does not factor in the actual risk and expectations of cable investors in the very uncertain world the Commission has created with cable price regulation. An 11.25 percent overall rate of return might well be appropriate for some cable operators in some circumstances, but only if the flaws and uncertainties in the Commission's price regulations that increase the riskiness of cable investments are eliminated.[69] For example, if the Commission permits a return on capital invested to acquire existing systems, an 11.25 percent rate of return might be adequate. But unless the Commission is prepared to amend its treatment of "excess" acquisition costs, the increased risks of a

[69] See Duquesne, 488 U.S. at 310 ("whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate-of-return given the risks under a particular rate-setting system . . .").

presumptive disallowance -- a risk not faced by the firms whose experience ostensibly underlies this prescription -- must be reflected in the rate of return prescribed in particular cases.

On a going-forward basis, the Commission should adopt rates of return based on case-by-case determinations reflecting how other issues are resolved. In keeping with the backstop function of cost-of-service regulation, it is critical that the Commission conduct precisely the type of analysis it rejected in the interim order:

> Such an undertaking would require cable operators to present, and franchising authorities of the Commission to review, analyses of matters such as the risks individual cable systems encounter in providing regulated cable service and the sources of capital available to finance those risks.[70]

The so-called "burdens" associated with this process are justified and indeed, necessary, if cable operators with unusually high costs are to be protected from confiscatory price regulation.[71]

IX. THE COMMISSION SHOULD CORRECT ITS ERRONEOUS TREATMENT OF TAXES IN THE INTERIM AND PROPOSED COST-OF-SERVICE RULES.

The interim rules proposed to be adopted as permanent err in at least three respects in their treatment of taxes: (a) treatment of taxes of cable operators that are not subchapter C

---

[70] Cost-of-Service Order at para. 154.

[71] It is of no avail that the Commission will "not foreclose parties to such proceedings from attempting to justify different rates of return." Id. at para. 156. Cable operators bear a "heavy burden" in doing so and thus it is unlikely that any party will succeed. Id. at n. 327.

corporations; (b) the synchronization of interest expense with ratebase for purposes of the income tax calculation; and (c) the treatment of deductibility of state taxes for purposes of federal taxes. These matters are summarized below and discussed more fully in the attached affidavit of Mr. Richard D. Treich of KPMG Peat Marwick.

A. Partnerships of Subchapter C Corporations Should Be Treated No Less Favorably than Partnerships of Individuals.

The Commission's requirement that cable operators reduce the income tax factor for subchapter S corporations and partnerships fails to deal fairly with partnerships in which the partners are subchapter C corporations which themselves pay taxes on the income of the partnership. This anomaly needs to be corrected.

B. Interest Expense Should be Synchronized.

The Commission's requirement that cable operators use actual interest expense for the tax calculation while using an implied debt cost in the rate of return calculation creates an anomaly and is inconsistent with typical practice in cost-of-service regulation. The rules should instead provide for synchronization of these calculations by using an interest expense calculated consistently with the rate of return calculation rather than actual, booked-interest expense.